No. 12961.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

HERSCHEL BULLEN, MARY H. BULLEN, J. C. HAYWARD and MARY S. HAYWARD,

Appellants,

vs.

ADAMANT COMPANY, WALTER B. SCOVILLE, JOE SEEPLE and HARRY WYNN; UNITED STATES OF AMERICA and RECONSTRUCTION FINANCE CORPORATION,

Appellees.

Upon Appeal From the United States District Court, Southern District of California, Central Division.

Reply Brief of Appellants Herschel Bullen, Mary H. Bullen, J. C. Hayward and Mary S. Hayward, Replying to Brief of Reconstruction Finance Corporation, as Respondent or Appellee.

WILLIAMSON, HOGE & CURRY, and
FULTON W. HOGE,
417 South Hill Street,
Los Angeles 13, California,
Attorneys for Appellants Herschel Bullen, Mary H. Bullen, J. C. Hayward and Mary S. Hayward.

Parker & Company, Law Printers, Los Angeles. Phone MA. 6-9171.

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Summary of Argument.

The brief of Reconstruction Finance Corporation, filed in its capacity as respondent, or appellee, in answer to the opening brief of the appellants Herschel Bullen, Mary H. Bullen, J. C. Hayward and Mary S. Hayward, raises three main points and we will reply to them in the same order, as follows:

(1) There *is* merit to the contention that the two for one agreement is binding upon the R. F. C., as the assignee of Treasure Company, and this is a controversy which should be determined by the District Court;

(2) The holders of participating royalty interests *do* have an equitable lien upon the lessee's interest to secure payment to them of their share of the net proceeds from the operation of the well prior to the seizure thereof by the Government; and

(3) These appellants *are* entitled to $\frac{1}{80.6}$th of $194,500.00 for each 1% participating royalty held by them.

I.

There Is Merit to the Contention That the Two for One Agreement Is Binding Upon the R. F. C., as the Assignee of Treasure Company, and This Is a Controversy Which Should Be Determined by the District Court.

On pages 6 and 7 of the R. F. C.'s brief certain letters written by Dr. Hayward are discussed. The contention is made that these letters establish that the Bullens and Haywards, whom the R. F. C. refers to as "the Haywards," have no rights to enforce the two for one agreement against Treasure Company. Before writing the letters, in which he made the statement that he and Mr. Bullen had always looked to Scoville for the payment of their money, Dr. Hayward had a conversation in the summer of 1939, with Mr. de Bretteville. de Bretteville claimed that he didn't know anything about the two for one agreement, as shown by the following testimony of Dr. Hayward [R. 1207-1208]:

> "A. We hadn't received any royalties or any two-for-one payment on the money we had sent down. We came down to see what was going on.
>
> Q. Did you make any inquiry of Mr. de Bretteville at that conference as to why you hadn't received any money? A. Yes, we asked him why we hadn't

been receiving our share of the 15 per cent money that was coming to us, why we hadn't received some royalties inasmuch as we were the small shareholders.

Q. What did he say? A. He said that he didn't know anything about the 15 per cent, and that he had been so involved in well expense that there wasn't any money for anybody because all the money that had been taken in had been used to pay off obligations and keep the well in operation.

Q. Was there any further discussion at that time, as you recall, of the 15 per cent or two-for-one deal, as it is sometimes referred to? A. Mr. de Bretteville said he knew nothing about it, and consequently it was not his responsibility; that he had never authorized it, and it was up to us to look for our money from Mr. Scoville if and when it came to him."

A fair analysis of the letters in question, which followed this conversation, is that they simply affirmed the self-evident proposition that if de Bretteville, or rather his company, Treasure Company, which was then in possession of the well, was not going to recognize the agreement, Dr. Hayward nevertheless expected Scoville to perform it, Scoville being the one who had dealt with the Bullens and Haywards in the first place, and therefore being the person to whom they looked to carry out the agreement.

Furthermore, Dr. Hayward was at that time seeking to have any money that was owing to Scoville on his participating royalties applied by de Bretteville on the two for one agreement. It must be borne in mind that Dr. Hayward is not a lawyer, and that as a practical layman,

he was trying to get his money in the easiest way possible. He testified on this point as follows [R. 1210-1211]:

> "Q. After that, did you make any attempt to get Mr. de Bretteville to pay you your two-for-one and charge it to Mr. Scoville's interest? A. Yes, I asked him on one occasion—I gave him a letter on one occasion stating what had happened and asked him to charge it up to Mr. Scoville and send it on down because I knew it would be all right with Mr. Scoville inasmuch as he had told us that it would be all right."

There is no waiver in the letters of any rights against Treasure Company, and if there were, no consideration for it is shown, nor any reliance upon it by Treasure Company. These conversations and the letters were long after the two for one agreement had been made, and the money of the Bullens and Haywards had been accepted by de Bretteville, as trustee and used to complete the well.

The R. F. C. fails in its attempt to dispose of our point that even though Scoville may not have been authorized to commit Treasure Company to the obligation of the two for one agreement in the first instance, Treasure Company cannot show such lack of authority, because it accepted the benefits of the transaction with knowledge of it. The case of *Canale, et al. v. Copello,* 137 Cal. 22, 69 Pac. 698 (1902), cited on page 7 of the R. F. C. brief, involved the question of whether a person who went into possession of leased premises and paid rent thereon for a while, and then moved out, became bound by the terms of the lease, and was therefore obligated to pay all rent accruing thereafter. The person who took such temporary possession was the wife of the deceased lessee. He had

made an assignment to her of the lease, which the court found had never been delivered and never took effect. It was contended that the wife, as assignee of the lessee, became bound under Section 1589 of the California Civil Code, because she accepted the benefits of the lease. In addition to holding that an assignment had not been completed, the court said that Section 1589 applies only when the person accepting the benefit of the transaction is a party to it. This language, however, should be read in the light of the facts of the case which the court was deciding. The rationale of the decision, or rather one ground of it, is simply that the section does not apply to the *assignee* of one of the original parties to the contract.

Acceptance of benefits is a substitute for authorization where a person purporting to act as the agent of another has attempted to bind him. An accurate statement of the rule is to be found in 6 Cal. Jur. 60, also cited by the R. F. C., where the following statement is made, in speaking of Section 1589:

> "But this doctrine applies only to a transaction to which the person accepting the benefit is, *or purports to be, or is claimed to be,* a party, but who would not have been bound by the transaction if he had not accepted the benefit thereof." (Italics ours.)

In making the two for one agreement, Scoville did purport to act for Treasure Company. Dr. Hayward testified as follows [R. 1191]:

> "A. Yes. Well, he said that he had invested money in an oil well here in California near the Venice Field that had the prospect of being a commercial producer, and that he was authorized and instructed by a committee which was responsible for drilling the well to go out and raise funds to complete

> the well which had been drilled to what he called the basement, a distance of something over 6,000 feet."

It will be recalled that the agreement of April 5, 1938 [Treasure Company's Exhibit QQ] and the addendum thereto [Treasure Company's Exhibit RR] between Treasure Company, Scoville, *et al.,* appointed a committee which at the time of the investment by the Bullens and Haywards had possession of the well, and the responsibility of completing it. That committee was acting for Treasure Company, as well as for the other parties to the agreement. In his negotiations with the Bullens and Haywards, Scoville was therefore purporting to represent Treasure Company, whether he had any authority to do so or not.

Judge Westover paid little attention to any evidence along this line, and rejected some offers of proof, doubtless because he had reached the conclusion that the two for one agreement was merely a personal matter, and not enforceable in this proceeding in any event. [Conclusion of Law VII, R. 152.] While we are confident that our rights under the two for one agreement at least bind the interest of Scoville, and that the judgment must be reversed on that ground alone, we believe that in any new trial which may be ordered the District Court, under applicable provisions of law to be laid down by this court, should go into the question of whose interests, in addition to Scoville's, are affected by the two for one agreement. It would be strange if all the other interested persons did not know of this agreement, and if they did, it is only just that all should contribute to the payment of the obligation it creates. The money put up by the Bullens and Haywards completed the well, without which there would have been no values for any one.

II.

The Holders of Participating Royalty Interests Do Have an Equitable Lien Upon the Lessee's Interest to Secure Payment to Them of Their Share of the Net Proceeds From the Operation of the Well Prior to the Seizure Thereof by the Government.

An equitable lien should be imposed in this case because there was a fiduciary relationship between Treasure Company, as operator of the well, and the holders of the participating royalty interests, and the fiduciary, which also had a beneficial interest, should not be permitted to stand on an equal footing with the other beneficiaries which it has wronged. Its beneficial interest, under the authorities cited on pages 34 and 35 of our opening brief should be charged with a lien to secure the payment to the other beneficiaries of the money which was wrongfully diverted from them.

The R. F. C. does not question these authorities, and presumably agrees to the general rule. It apparently questions the existence of the fiduciary relationship, and also raises the question as to whether any money was actually owed. At page 15 of the R. F. C. brief it is said:

> "Nowhere in the *La Laguna* opinion is there any suggestion that when the lessees assigned to the defendants' fractional interests in the oil and gas production from the lease, the lessees agreed, in effect, to become trustees for the assignees.",

and they rely on this case as holding that no such trust relationship exists. That case, *La Laguna Ranch Co. v. Dodge, et al.,* 18 Cal. 2d 132, 114 P. 2d 351, simply holds that a lessee who has made assignments of royalty in-

terests out of the share to which he is entitled as lessee may thereafter *in good faith* surrender the lease to his lessor. So far as appears from the facts of the case, it may simply have been one where, as frequently happens, the lessee fails to discover oil, and quitclaims the premises to the lessor. Indeed, he might have been obligated to do so under the terms of the lease. At any rate, the usual oil lease, as is well known, gives the lessee the right to surrender the lease, or any part of the premises covered thereby, thus giving him a means of avoiding the continuing obligation to conduct exploration or pay rent in lieu thereof. The rule of *La Laguna* is simply that holders of royalties assigned out of the lessee's interest take subject to the lessee's right of surrender. The question of any fraudulent exercise of the right is expressly reserved by the opinion, and the existence or non-existence of a fiduciary relationship between the operating lessee and the royalty holders was not involved.

The California court has expressly held, however, that such a relationship exists. (*Differding v. Ballagh,* 121 Cal. App. 1, 8 P. 2d 201.) In this case three individuals who held an oil lease made assignments of royalty interests to finance the drilling of a well. The royalties so sold were not subject to expenses of operation. Thereafter two of the lessees entered into a transaction with the third one whereby, for a valuable consideration, they assigned to him a similar royalty, entitling the holder to 5% of the gross proceeds of oil produced and saved. In this action that lessee sought to assert his ownership

of this 5% overriding royalty. The court below held against him. The District Court of Appeal affirmed the judgment, and a petition for hearing by the Supreme Court was denied. The case involved the precise question of whether a fiduciary relationship exists between an operating lessee and persons to whom the lessee has assigned royalty interests. In speaking of the contentions made by the lessee holding the 5% overriding royalty assigned to him by the other two lessees, the court said, at 121 Cal. App. page 6:

> "Their soundness all depends on whether or not there was a relation of trust and confidence existing between the production owners and Differding and his two cotrustees. The question follows of whether or not the assignment of the overriding royalty to Differding resulted in detriment to the production owners. We will confine our discussion to these two questions."

On the first question, that is to say, the existence of the relation of trust and confidence, the court points out that the production owners, that is, the holders of the first royalty assignments, were not entitled to possession of the leased property. Their assignments entitled them only to a certain percentage of oil produced and saved by the lessees. They entrusted their money, a considerable amount, to the lessees. Their chances for returns on their investments, assuming that oil existed, depend entirely upon the skill, industry, intelligence, honesty and integrity of the lessees. The lessees had the money and

independent power in the manner of its expenditure in drilling the wells, and the royalty holders were given no rights to even advise on these matters. The court concludes at page 7:

> "If these facts did not create a condition in which the elements of trust and confidence between two groups must have existed, it would be hard to imagine one that did."

The court then goes on to conclude (p. 9), that the transfer to Differding, one of the lessees, of the 5% overriding royalty, would adversely affect the interest of the original royalty holders, it having been found by the court below that the percentage of total production which the lessees would have left, after this assignment, would not be sufficient to pay the cost of operating the well.

All the reasons given by the court in the case cited for the existence of a fiduciary relationship apply with equal force in the case at bar. After the agreement of April 5, 1938, was terminated, the royalty holders and their assigns had no rights to possession of the well, had no voice in the management, and were required to look only to Treasure Company for the production of oil and the proper application of the proceeds of sale.

As to the question of whether or not there were any net proceeds to be distributed, it would seem that there should have been. The gross proceeds of sale of the oil produced by the well during its administration by Treasure Company amounted to over $200,000.00 [R. 1236, and see p. 8 of

R. F. C. brief], and if the Government experts were anywhere near right in their testimony of what the expenses should have been [R. 815], then the participating royalty holders should have got substantial sums. At least there was a sufficient *prima facie* showing to justify an accounting, which the District Court refused to give.

So far as the *Vickers* case, and the pending accounting action brought by *Scoville, et al.,* are concerned, it is sufficient to say that the Bullens and Haywards are not parties to those actions. It would seem, however, that all royalty holders, whether parties to these actions or not, should be entitled to assert their liens in this action, wherein is the only property against which the liens could now exist. The liens attached to the leasehold, which has now disappeared, and the award stands in its place. In any other action, the royalty holders could recover only a personal judgment.

The case of *Florida Beaches, et al. v. Niagara Investment Co., et al.,* 148 F. 2d 963, cited on page 19 of the R. F. C. brief, does not support their position. In that case, the equities asserted attached to other lands in addition to those involved in the condemnation action. Even so, the court was disposed to keep the money intact until the other action had been determined, saying, in the language quoted at the bottom of page 20 and top of page 21 of the R. F. C. brief:

> "The most it ought to do would be to keep the fund safe, if that is shown to be necessary, until the parties can protect their rights in it elsewhere."

III. These Appellants Are Entitled to 1/80.6th of $194,500.00 for Each 1% Participating Royalty Held by Them.

We have no quarrel with the R. F. C.'s contention (pp. 23 and 25 of its brief) that the award of $194,500.00 was given for 100% of the working interest in Treasure Well No. 8. The question is: What part of that working interest is owned by the royalty holders, and what is owned by the lessee? As pointed out in our opening brief, p. 36, *et seq.,* that depends on what was assigned by the lessee to the royalty holders. The R. F. C. apparently does not question our argument, there made, that a 1% royalty assignment was an assignment of 1% *of all oil to be produced and sold,* in other words, 1/100th of 100% *of total production.* This is quite different from 1/100th of 100% *of the working interest,* because, by stipulation, the working interest was only 80.6% of total production. The remainder, 19.4%, is the landowners' royalty (p. 13 of R. F. C.'s opening brief, note 8), which, of course, was not included in the valuation of the working interest. (R. F. C.'s opening brief p. 14.) It is simply a matter of arithmetic that 1/100th of 100% is the same as 1/80.6th of 80.6%.

The award of $194,500.00 represents *only the working interest,* as everyone concedes. Since the working interest is 80.6% *of total production,* the award represents 80.6% *of the total production.* To give the royalty holders only 1/100th of the award would, therefore, give them 1/100th of 80.6% of total production, which is manifestly less than

$\frac{1}{100\text{th}}$ of 100% of total production, the amount to which they are entitled by their assignments.

What the Bullens and Haywards are entitled to is $\frac{1}{80.6\text{th}}$ of 80.6% of total production, or $\frac{1}{80.6\text{th}}$ of $194,500.00 for each 1% porticipating royalty held by them, which is $2,413.00 for each 1%, or a total of $4,826.00 to these appellants as the value of their participating royalties.

To give them less is to re-write their assignments.

Respectfully submitted,

WILLIAMSON, HOGE & CURRY, and
FULTON W. HOGE,

Attorneys for Appellants Herschel Bullen, Mary H. Bullen, J. C. Hayward and Mary S. Hayward.